STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
AUTOTOTE LIMITED	:	DETERMINATION
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ending June 30, 1983, June 30, 1984 and June 30, 1985.	:	

Petitioner, Autotote Limited, P.O. Box 6009, 100 Bellevue Road, Newark, Delaware 19714-6009, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ending June 30, 1983, June 30,1984 and June 30, 1985 (File No. 805477).

On November 10, 1988 and November 17, 1988, respectively, petitioner and the Division of Taxation consented to have the controversy determined on the submission of documents without hearing, with all briefs to be submitted by March 15, 1989. After due consideration, Jean Corigliano, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether petitioner was required to add back 90 percent of its Federal deduction for interest paid on indebtedness to a shareholder owning more than 5 percent of petitioner's capital stock.

II. Whether the Commissioner of Taxation and Finance abused his discretion by failing to grant petitioner permission to file combined reports with its parent corporation.

FINDINGS OF FACT

1. Petitioner, Autotote Limited ("Limited"), was incorporated under the laws of the State of Delaware on September 17, 1980. Limited is authorized to transact business in New York, Delaware, and other states.

2. Limited is a wholly-owned subsidiary of Autotote Systems, Inc. ("Systems"). Systems was incorporated under the laws of the State of Delaware on May 19, 1979. Systems is not authorized to transact business in any state other than Delaware. System's principal place of business is 100 Bellevue Road, Newark, Delaware. It shares these offices with Limited.

3. Limited's principal business is the design, engineering, manufacturing, marketing and operation of parimutuel wagering systems called "Totalisators". The Totalisator systems are used at horse and greyhound racetracks and jai alai frontons throughout North America, South America and Europe. In New York, Limited services parimutuel equipment at many horse race

tracks and off-track betting parlors.

4. Systems was formed in 1979 to be the holding company for a leveraged buyout of Limited, then an Australian corporation wholly owned by a second Australian corporation. To effect the buyout, Systems borrowed approximately 16 million dollars from institutional lenders in August 1979. Since then, its business activities have related primarily to financial transactions associated with its buyout of Limited.

5. Systems has no employees, offices or telephone lines of its own. Rather, it utilizes Limited's personnel and facilities to perform its functions. The officers and directors of Limited and Systems are identical. Both Limited and Systems hold Board of Directors meetings at the same time and at the same place.

6. In June 1981, Systems refinanced its debt, incurred in the acquisition of Limited, by means of a private placement memorandum underwritten by Drexel Burnham Lambert, Incorporated. At the time of this refinancing, Systems lent the proceeds of the refinancing to Limited so that the interest cost associated with the outside debt properly matched the income used to service the debt. Net proceeds from the offering amounted to $14,600,000.00 which were used as follows:

(a) $7,800,000.00 for reduction of bank debt incurred in connection with Systems's acquisition of Limited in 1979;

(b) $5,000,000.00 for reduction of bank debt incurred to finance Limited's leased equipment;

(c) $730,000.00 for the purchase of buildings at 50 Bellevue Road and 100 Bellevue

Road, Newark, Delaware which were leased to Limited after acquisition;

(d) the remainder for working capital.

7. In June 1983, Systems again refinanced its outside debt because market interest rates had fallen dramatically. Moreover, the continued viability of Limited and Systems was then in doubt due to operational problems and the cost of debt service. In this transaction, approximately one-half of Systems's outside debt was replaced with new Class A Preferred Stock. Under the terms of the stock issue, the Preferred Stock was to be redeemed by Systems within five years. If it was not, Systems would be subject to substantial penalties. The other one-half of the outside debt was refinanced over a shorter term at a reduced interest rate. The related debt of Limited to Systems, which had first been established in June 1981, was not changed after the June 1983 refinancing.

8. During Limited's fiscal year ended June 30, 1983, Limited paid interest totaling $3,078,141.00. All of this amount was paid directly by Limited to outside debt holders, and not to Systems, and all of this amount was deducted on Limited's New York corporation franchise tax report for the fiscal year ended June 30, 1983. Funds borrowed by Systems to pay for the acquisition of Limited were reloaned by Systems to Limited at an equivalent interest rate. To reflect these transactions Systems and Limited set up intercompany accounts which constituted an account receivable for Systems and account payable for Limited. When Limited paid interest directly to lenders, the intercompany accounts showed interest paid from Limited to Systems, and then from Systems to debt holders. The actual flow of funds was from Limited to debt holders.

9. After Systems restructured its debt in June 1983, reducing its outside debt from $20,000,000.00 to $10,000,000.00 and replacing $10,000,000.00 of the outside debt with new

Class A Preferred Stock, Limited continued to service its $20,000,000.00 debt to Systems. Because the underlying debt had been restructured, Limited paid directly to outside debt holders only that portion of the interest which continued to be held by outside creditors. The remaining portion of the principal and interest of its indebtedness to Systems was paid directly to Systems.

10. On its New York corporation franchise tax report for the fiscal year ended June 30, 1984, Limited deducted 100% of that portion of the interest paid directly to outside creditors, and only 10% of other interest paid to Systems.

11. During its fiscal year ended June 30, 1985, Limited continued to make interest payments directly to outside debt holders. The interest expense deducted on Limited's New York corporation franchise tax report for the fiscal year ended June 30, 1985, represented 100% of the interest paid directly to outside bond holders and 10% of the interest paid directly to Systems.

12. In December 1985, Systems redeemed its Class A Preferred Stock with the proceeds of a bank loan. The related debt of Limited to Systems was not changed after the redemption. The resulting capital structure of Systems (approximately $10,000,000.00 of bank debt and approximately $10,000,000.00 to note holders) has remained the same since December 1985.

13. The transactions described in Findings of Fact 8, 9, 10 and 11 reflect the flow of actual funds. On their books and records, and with respect specifically to the intercompany account between Limited and Systems, Systems is shown as receiving all the interest, and paying out approximately one-half of the amount to outside debt holders.

14. Limited and Systems have filed consolidated United States corporation income tax returns since March 27, 1981, the day on which Limited became a Delaware corporation and

therefore eligible to file a United States consolidated return with Systems.

15. In fiscal years 1983 through 1986, Limited filed Federal income tax returns and State corporation franchise tax reports showing its income as follows:

Year	New York	Everywhere
1983	$ 387,720.00	$19,569,835.00
1984	382,538.00	22,250,427.00
1985	2,723,684.00	25,626,739.00
1986	5,209,607.00	27,573,976.00

16. The following table shows the amount of intercompany interest due to Systems from Limited in each of the fiscal years 1983-1986 as shown on Limited's and Systems's books and records.

Year	Amount of Interest
1983	$3,078,141.00
1984	3,092,148.00
1985	3,150,008.00
1986	3,219,406.00

17. The intercompany transactions between Systems and Limited consist of: (a) Systems obtaining from third parties and then reloaning to Limited substantial funds for capital and operating purposes; and (b) Limited making substantial principal and interest payments to Systems.

18. The Division of Taxation conducted a field audit of Limited's tax liability for the years ended June 30, 1983, June 30, 1984 and June 30, 1985. As a result of the audit, several adjustments were made to Limited's reported tax liability. The only adjustment challenged by Limited concerns the interest payments shown in Finding of Fact "16". The auditor determined that, in calculating its New York income, Limited should have added back to its Federal income all interest payments from Limited to Systems, as shown on the intercompany accounts, minus a 10 percent exclusion.

At the time of the audit, Limited expressed its opinion that if the interest payments were to be added back, the Division of Taxation should also require the filing of combined reports. The auditor informed Limited that the Division will not allow a holding company to file on a combined basis with a subsidiary corporation.

19. On January 16, 1987, Limited filed with the Division of Taxation a request for permission to file reports on a combined basis with Systems for the fiscal years ending June 30, 1983, June 30, 1984, June 30, 1985 and subsequent years. There is no evidence in the record that the Division directly responded to petitioner's request.

20. On May 29, 1987, as a result of the audit, the Division issued to Limited the following notices of deficiency :

Period Ending	Tax	Interest	Penalty	
June 30, 1983	$ 42.00	$ 20.00		
June 30, 1984	2,028.00	659.00		
June 30, 1985	10,058.00	1,830.00		$1,006.00
June 30, 1985	1,332.00*	242.00		

*Temporary metropolitan transportation business tax surcharge.

21. Limited and the Division of Taxation entered into a stipulation of facts which has been substantially incorporated into this determination as Findings of Fact "1" through "19".

CONCLUSIONS OF LAW

A. The starting point in determining a corporation's New York taxable income is its Federal taxable income (Tax Law § 208.9). The taxpayer is then required to make certain specified modifications (Tax Law § 208.9[a], [b]). Among the items to be added to Federal taxable income is 90 percent of interest paid to shareholders owning more than five percent of the corporation's issued capital stock. During the years in issue, Tax Law § 208.9(b)(5) provided that entire net income shall be determined without the exclusion, deduction or credit of:

> "ninety per centum of interest on indebtedness directly or indirectly owed to any stockholder or shareholder (including subsidiaries of a corporate stockholder or shareholder), or members of the immediate family of an individual stockholder or shareholder, owning in the aggregate in excess of five per centum of the issued capital stock of the taxpayer, except that such interest may, in any event, be deducted
>
> (i) up to an amount not exceeding one thousand dollars,
>
> (ii) in full to the extent that it relates to bonds or other evidences of indebtedness issued, with stock, pursuant to a bona fide plan of reorganization, to persons, who,

prior to such reorganization, were bona fide creditors of the corporation or its predecessors, but were not stockholders or shareholders thereof,

(iii) in full where the investment allocation percentage is applied to entire net income, and

(iv) in full to the extent that it is paid to a federally licensed small business investment company" (Tax Law § 208.9[b][5], amended by L 1987, ch 817, § 7, repealed as amended applicable for tax years beginning on or after January 1, 1989).

B. For the years at issue, Limited's and Systems's intercompany accounts show that Systems borrowed from unrelated creditors money which it lent to Limited and that Limited made payments of principal and interest to Systems which Systems then passed through to its own creditors. All interest payments made by Limited in 1983, and a portion of the payments it made in 1984 and 1985, were made directly to the outside debtholders, notwithstanding entries made in the intercompany accounts. Limited now argues that interest payments it made directly to outside debtholders should not be subject to the addback provision of Tax Law § 208.9(b)(5). It bases its position on the theory that Systems acted merely as a conduit through which Limited borrowed money from and repaid money to unrelated debtholders. Limited maintains that in strictly construing the interests payments as payments made by Limited to its 100 percent stockholder, Systems, the Division of Taxation distorts the intent of section 208.9(b)(5) which is the prevention of tax avoidance by disguising the distribution of profits as the payment of interest (see, Matter of Norcliff Thayer v. Chu, 123 Misc 2d 16).

The Division of Taxation disallowed the exclusion of interest paid to outside debtholders on the ground that all interest payments were made to Systems which borrowed money which it

then re-lent to Limited. The Division's position is that, since Tax Law § 208.9(b)(5) contains no specific exception permitting a taxpayer to exclude interest payments passed through from the shareholder to an outside debtor, all such interest is subject to the addback rule of section 208.9(b)(5).

There are no provisions in the Tax Law or the regulations which provide an exception to Tax Law § 208.9(b)(5) under the conduit theory advanced by petitioner. For a number of years, however, the Division of Taxation followed a policy of allowing a corporation to deduct interest payments made to a shareholder under circumstances such as those existing here (see, e.g., MC Minerals Corporation, Advisory Opinion, March 27, 1981 [TSB-H-81(21)C]); Kowa Realty (America) Ltd., Advisory Opinion, December 9, 1981 [TSB-A-81(20)C]). Because such a policy was not supported by the statute, the Division later reversed its position and declared that it would no longer recognize the conduit theory (Technical Services Bureau Memorandum, September 30, 1983 [TSB-M-83(24)C]). In January 1985, the former State Tax Commission issued a decision interpreting section 208.9(b)(5) and definitively stating that interest paid by a corporation to a shareholder and then passed through to an outside lender was not fully excludable from entire net income. However, the Commission further stated that deductions of such interest payments would be permitted for payments of interest made or accrued prior to January 1, 1984 (Matter of Mix 'N' Match of Miami, State Tax Commission, January 18, 1985). In accordance with this decision, the deficiency assessed for the tax year ending June 30, 1983 is cancelled. In addition, so much of the deficiency for the fiscal year ending June 30, 1984 as is attributable to interest payments made or accrued prior to January 1, 1984 shall also be cancelled.

C. Limited next argues that the Commissioner of Taxation and Finance abused his discretion by not permitting Limited and Systems to file amended reports on a combined basis for fiscal years 1983, 1984 and 1985 and to continue filing on a combined basis in subsequent

years. It is Limited's position that separate filing by Limited results in a distortion of its New York income. The intercompany loans from Systems to Limited produce a substantial amount of intercompany interest expense on Limited's books and interest income on Systems's books. If a combined return were permitted, the intercompany interest transactions would be treated as subsidiary capital and thereby be excluded from the calculation of entire net income. Since the Division of Taxation has rejected Limited's conduit theory, separate filing requires Limited to add back 90 percent of its interest expense to income. Limited's position is that separate filing, because it results in the inclusion of intercompany interest expenses in income, does not reflect the overall financial position of Limited and distorts Limited's New York taxable income.

D. Tax Law article 9-A imposes a tax on foreign corporations doing business in New York on the basis of the business they generate in the State (Tax Law § 209.1). In order to properly reflect that tax liability, subdivisions 4 and 5 of Tax Law § 211 authorize the Commissioner of Taxation and Finance to require or permit corporate taxpayers subject to New York State tax to file combined reports with other corporations, irrespective of whether such corporations are doing business in the State, where, as here, the parent owns or controls substantially all of the stock of the subsidiary and the corporations are, in substance, part of a unitary business conducted by the entire group of corporations (Matter of Campbell Sales Co. v. New York State Tax Commn., 68 NY2d 617, 619-620; see also, Matter of Wurlitzer Co. v. State Tax Commn., 35 NY2d 100; 20 NYCRR 6-2.5[a]).

There is no statutory right to file combined reports; rather, Tax Law § 211.4 gives the Commissioner the discretion to permit or require such filing. The current regulations, effective for all taxable years ending on or after December 31, 1983, allow the filing of combined reports where three tests have been met: (1) a stock ownership test (20 NYCRR 6-2.2[a]); (2) a unitary business test (20 NYCRR 6-2.2[b]); and (3) a distortion of income test (20 NYCRR 6-2.3). In determining whether a corporation is part of a unitary business the Division of Taxation will

consider whether its activities are related to the activities of other corporations in the group, such as: (1) manufacturing or acquiring property for other corporations in the group, (2) selling goods acquired from the other corporations, or (3) financing sales of other corporations in the group (20 NYCRR 6-2.2[b][1]). The Division will also consider whether the corporation is engaged in the same or related lines of business as other corporations in the group (20 NYCRR 6-2.2[b][2]).

20 NYCRR 6-2.3(a), containing the third requirement, provides that the Division of Taxation "may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers." Such distortion is presumed to occur when the taxpayer files on a separate basis if there are substantial intercorporate transactions among the corporations. In considering whether there are substantial intercorporate transactions, the Division of Taxation will consider transactions directly connected with the business conducted by the taxpayer such as, (1) manufacturing or acquiring goods or performing services for other corporations in the group, (2) selling goods acquired from other corporations in the group, (3) financing sales of other corporations in the group, and (4) performing related customer services using common facilities and employees (20 NYCRR 6-2.3[c]). The Division will permit or require the filing of a combined report where substantial intercorporate transactions do not occur if the filing of a report on a separate basis nevertheless results in a distortion of the taxpayer's activities, business, income or capital in New York (20 NYCRR 6-2.3[d]). Where, as here, the taxpayer seeks permission to file on a combined basis, it must establish that separate reporting does not properly reflect the business that it transacts in New York (see, Matter of Campbell Sales Co. v. New York State Tax Commn., supra at 620).

The unitary business test and the distortion of income test are, in fact, interrelated factors. A unitary business will always be found where there are substantial intercorporate transactions

such that 50 percent of a corporation's receipts or expenses are from one or more of the qualifying activities set forth in 20 NYCRR 6-2.3(c). In fact, the activities considered by the Division of Taxation in determining whether a unitary business exists are almost identical to the transactions considered to determine whether there are substantial intercorporate transactions (compare, 20 NYCRR 6-2.2[b] with 20 NYCRR 6-2.3[c]). In some cases, the courts have treated the unitary business test and the requirement of substantial intercompany transactions as facets of a single inquiry. In Matter of Fedders Corp. v. State Tax Commn. (45 AD2d 359), the court upheld the State Tax Commission's determination to require the filing of combined reports where the only substantial intercompany transactions found were intercompany loans. In Matter of American Intl. Group v. Tully (89 AD2d 687), the court annulled a determination of the State Tax Commission and permitted a holding company to file combined reports with its wholly-owned subsidiary despite the absence of any intercompany sales of products and transactions between the parent and its subsidiary, since the court found that the subsidiary financed the purchase of products sold to other subsidiaries and acted as a department of a unitary business conducted by the entire group with substantial intercompany transactions. Finally, in Matter of Coleco Industries v. State Tax Commn. (92 AD2d 1008), the appellate court held that in determining whether combined reporting should be permitted, the ultimate "question is whether, under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income" (Matter of Coleco Industries v. State Tax Commn., supra at 1009).

The question of whether combined reporting should be permitted or required necessitates a factual inquiry in each case. The facts submitted by the parties here establish that Systems and Limited were, in substance, part of a unitary business conducted by the two corporations. Limited was engaged in the design, manufacture, marketing and operation of automated wagering equipment, and Systems financed Limited's business operations. Systems does not manufacture or acquire goods for Limited, sell its products or finance sales to Limited's

customers. However, Systems lends money to Limited and obtains outside financing for Limited's business activities. There is complete integration of the operations of Limited and Systems, with Systems relying entirely on Limited's facilities and personnel to perform its functions. Furthermore, Limited has established that separate reporting results in significant distortion of its New York income. Under these circumstances it appears that the filing of combined reports would have been appropriate.

E. A taxpayer seeking permission to file on a combined basis must file a written request at least 30 days before the end of its fiscal year, providing detailed information as required by the Division of Taxation (20 NYCRR 6-2.4[a]). The Division's policy of not considering an untimely request except in the case of unusual or extraordinary circumstances has been upheld by the courts (Matter of Fuel Boss v. State Tax Commn., 128 AD2d 945). The Division maintains that even if Limited and Systems are conducting a unitary business, no unusual or exceptional circumstances exist in this case which warrant granting petitioner and its parent corporation permission to file amended returns on a combined basis. Petitioner argues that the Division's change of policy regarding the conduit theory of interest deductions is such a circumstance.

Limited's request to file combined reports was received in January 1987, over three years from the time the Division issued a policy memo discontinuing its recognition of the conduit theory and two years from the time the State Tax Commission issued a decision upholding the Division's interpretation of section 208.9(b)(5) of the Tax Law (see, Matter of Mix 'n' Match of Miami, supra). Limited has presented no facts to justify its waiting two years before filing a request for permission to file on a combined basis. Mere ignorance of the Commission's interpretation of the statute is not such an unusual or extraordinary circumstance as would warrant granting permission to file amended reports on a combined basis. Therefore, the Division properly denied Limited permission to file a combined report for the audit years.

However, while tax years beginning on or after July 1, 1985 are not subjects of this determination, it is noted that Limited's request to file on a combined basis was timely made for the fiscal year ended June 30, 1987 and the years after.

F. The petition of Autotote Limited is granted to the extent indicated in Conclusion of Law "B"; the notices of deficiency issued on May 29, 1987 shall be modified accordingly; and, in all other respects, the petition is denied.

DATED: Troy, New York
July 13, 1989

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE